

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
BRIEF**

77-6134/36

ORIGINAL
WITH PROOF
OF SERVICE

To be argued by
MARTIN H. KAPLAN

UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT

COMMODITY FUTURES TRADING COMMISSION,

Plaintiff-Appellee,

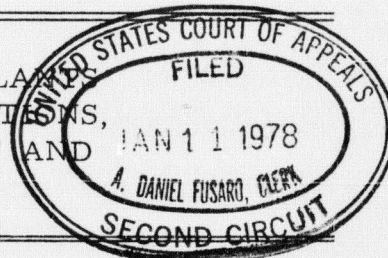
vs.

CROWN COLONY COMMODITY OPTIONS, LTD.,
ALLEN M. GOLDSCHMIDT, ARNOLD TENNEY,
JOSEPH ALTER and JOEL STEINER,

Defendants-Appellants.

ON APPEAL FROM AN ORDER OF THE UNITED STATES
DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF DEFENDANTS-APPELLANTS
CROWN COLONY COMMODITY OPTIONS, LTD.,
ALLEN M. GOLDSCHMIDT AND
ARNOLD TENNEY



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(6887)

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PRELIMINARY STATEMENT

This is an appeal by CROWN COLONY COMMODITY OPTIONS, LTD., ALLEN M. GOLDSCHMIDT and ARNOLD TENNEY, Defendants, from a Preliminary Injunction issued by the United States District Court for the Southern District of New York (Hon. Edward Weinfeld presiding) in a civil suit brought by the COMMODITY FUTURES TRADING COMMISSION ("CFTC"), under the provisions of the Commodity Exchange Act (7 U.S.C. § 1 et seq.).

STATEMENT OF THE ISSUES

1. Whether there was sufficient evidence to warrant a denial of Defendants' Joint Motion for a one week continuance made orally at the outset of the hearing, and whether such denial was an abuse of discretion, a denial of due process of law and of an opportunity to be heard?
2. Whether a Preliminary Injunction should issue for alleged conduct violative of the Anti-Fraud Provision of the Commodity Futures Trading Commission Act, when both the evidence before the Court and also the Court itself are silent with respect to the existence of scienter and other equitable considerations on the part of the Defendants?
3. Whether the Preliminary Injunction of the District Court is effective as to Defendant, ARNOLD TENNEY, when, at the time of the hearing, there was no proof of service having been made upon him.
4. Whether, following a hearing on a Preliminary Injunction Defendants should be allowed more than 24 hours to file supplemental Memoranda of Law?
5. Whether the Court below erred in denying Defendants' Joint Motion to Dismiss or, in the alternative, for a more definite statement of the Complaint on the grounds that the Complaint failed to satisfy the requirements of Rule 9 of the Federal Rules of Civil Procedure?
6. Whether the Anti-Fraud Statute violates the Fifth Amendment of the Constitution, as interpreted, because it bears no rational relationship to the end sought to be achieved?

STATEMENT OF FACTS

This is an interlocutory appeal by Defendants, permitted under 28 U.S.C. §1292(a)(1),^{1/} from a decision and order of the U.S. District Court for the Southern District of New York, (Weinfeld, J.),^{2/} entered on June 15, 1977, granting preliminary injunctive relief.

On May 31, 1977, following a seven month investigation, Plaintiff, COMMODITY FUTURES TRADING COMMISSION, (hereinafter "CFTC" or "Commission"), filed its Complaint for a Temporary Restraining Order, Preliminary Injunction, Permanent Injunction and other relief. Its action was based in large part upon the Anti-Fraud Provision of the CFTC Act as applied to alleged fraudulent practices in the offering and sale of London commodity options by the Defendant, CROWN COLONY COMMODITY OPTIONS, LTD. (hereinafter "CROWN COLONY") and the remaining Defendants who are some of its principals and employees.^{3/} Hearing on the TRO was held on June 2, 1977 with all Defendants except ARNOLD TENNEY before the Court. The Court refrained from issuing a TRO and set down a hearing on the Preliminary Injunction for June 6, 1977.

At the outset of the second hearing on June 6, 1977, all Defendants joined in a motion for a short continuance of one week. They argued that the evidence presented at the earlier hearing established beyond a doubt that the corporate Defendant had ceased all operations of offering and sale of London commodities several weeks

^{1/} Orders of Preliminary Injunction as well as orders directing the conduct of litigation are permitted thereunder, See, for example, Semmes Motors, Inc. v. Ford Motor Co., 429 F.2d 1197 (2d Cir. 1970); Mercury Motor Express v. Brinke, 475 F.2d 1086 (5th Cir. 1973); 16 Wright, Miller, Cooper, Gressman, Federal Practice and Procedure §3924 at p. 67 (1977 ed).

^{2/} Reported at 434 F. Supp. 911 (1977) and (Current) Comm. Fut. L. Rep. (CCH) ¶20,429 (1977).

^{3/} GOLDSCHMIDT is President of CROWN COLONY, TENNEY is Director, ALTER is a Vice President, STEINER, PATTERA, DAVIDSON and YALES are employees.

earlier for reasons not related to the lawsuit, that said evidence remained un rebutted, and that there was no reason, therefore, to proceed immediately to a hearing on the Preliminary Injunction. They argued additionally that the Court's announcement that should the Commission's evidence support the allegations, a Preliminary Injunction would issue^{4/} increased the importance of impeachment and cross-examination to their case and that for such a defense they required more than three days to prepare.

The Court denied this motion and the hearing took place immediately.

At the close of the hearing, Defendants requested an opportunity to submit Memoranda of Law. The Court granted the request, allowing 24 hours for the submission, but stated that it would begin work on its opinion prior to that time.^{5/}

Although the particular statutes which this appeal offers for Appellate construction are remarkably similar to certain sections of the Securities Exchange Act of 1934,^{6/} surrounding which there is a large and specialized body of case law, it is undisputed among the parties and the Court below that Congress intended that the Courts make a "case by case", rather than a "blanket" application of the Securities case law to the commodities field.^{7/} In the forefront of the recent developments

4/ Transcript June 2, 1977 p. 41.

5/ Transcript June 8, 1977 544, 545.

6/ Compare §4b of the CFTC Act of 1974, codified as 5 U.S.C. §6b and Commission Rule 30.01 promulgated thereunder with §10b of the Securities Exchange Act of 1934, 15 U.S.C. §7Bj and Securities Exchange Commission Rule 10b-5.

7/ 40 F.R. at 26,606, cited in CFTC v. J.S. Love & Associates Options, Inc. 422 F. Supp. 652 (S.D.N.Y. 1976).

in Securities Case Law, is a decision of the United States Supreme Court^{8/} requiring a finding of scienter, or intent to defraud as a necessary element in the offense of securities fraud. In Part II of this Appeal, Defendants-Appellants, CROWN COLONY, GOLDSCHMIDT and TENNEY urge upon the Court application of this principle to the regulation of commodities, as well as the analysis performed by the Supreme Court upon the underlying facts.

Since a Preliminary Injunction was issued subsequent to a judicial finding that there was no present activity which was actionable, the Appeal presents the question of what findings are sufficient to warrant Preliminary Injunctive relief when the likelihood of immediate or irreparable harm is merely inferential, as well as what showing should be sufficient to warrant a grant of additional time to prepare.

^{8/} Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

POINT I

THERE WAS INSUFFICIENT EVIDENCE ON
THE RECORD TO WARRANT A DENIAL OF
DEFENDANTS' JOINT MOTION FOR ADEQUATE
TIME TO PREPARE AND SUCH DENIAL CON-
STITUTED ABUSE OF DISCRETION AND A
DENIAL OF DUE PROCESS OF LAW.

The threshold question presented on this Appeal is whether the trial Court abused its discretion, and the Defendants were denied due process of law when the Court denied their motion of June 6, 1977 for a one week continuance and instead went forward with a full evidenciary hearing.

This case first came before the Court on June 2, 1977 for a hearing on the CFTC's motion for a Temporary Restraining Order against all Defendants. Although a TRO is permitted by both the CFTC Act ^{9/} and the rules of the Southern District Court when the Defendants are before the Courts, as they were at that time no such relief was granted. The Court looked instead to the affidavit of GOLDSCHMIDT ^{10/} which remained uncontradicted through the proceedings. It affirmed, among other things, that the Defendant Corporation and all its principals ^{11/} had ceased all activity in the offer and sale of London Commodity Options several weeks prior to the initiation of the

^{9/} 5 U.S.C. §13a-1

^{10/} Joint Appendix , Tr. June 2, 1977 p. 18.

^{11/} Some of the employees were already working for another firm.

instant lawsuit for reasons completely unrelated to the suit.^{12/}

The Plaintiff Commission and the Court both acknowledge the fact that the affidavit, if true, rendered unnecessary the relief sought by way of the TRO (Tr. June 2, 1977 page 40). The Commission was unable to contradict the affidavit.

Between the first hearing on June 2, 1977 and the second hearing on June 6, 1977, counsel for the Defendants, CROWN COLONY, TENNEY and GOLDSCHMIDT, repaired to Miami to acquaint themselves with their new clients and the facts of the case. When they returned on June 4, the Commission served upon them some 2,000 pages of additional material. (Tr. June 6, 1977 24, 25). This material informed Defendants for the first time of the names of those individuals who would appear.

The motion for one week's additional time to prepare, which is presently under consideration, was made at the outset of the proceedings on Monday, June 6, before any testimony was taken.^{13/} (Tr. June 6, 1977 p. 18 et. seq.). Denial of this motion constitutes the first assignment of error.

In order to fully appreciate the prejudice which this ruling caused Defendants, it is necessary to understand the theory of the Commission's case. The CFTC proposed that Defendants were engaged in a course of doing business which created a substantial likelihood that repeated illegalities would occur on a routine basis. Some of those practices and activities the Commission sought to prove as

^{12/} CFTC Regulation 32.6, 17 C.F.R. §1.20 (1977), originally effective 12/27/76 requires segregation by the broker of 90% of the customers premium in a commodity options transaction. Thus a broker must either have a considerable quantity of ready cash on hand (approximately equal to 90% of his anticipated sales, multiplied by the average life of an option) or must charge an exorbitant premium (approximately equal to 9 times the value of the London option) to comply. The effective date of 32.6 was delayed by Court Order until April 25, 1977. CROWN COLONY ceased all offer and sale from all locations, shortly thereafter.

^{13/} Since the motions were submitted prior to the opening cry, it is F.R. Civ. P. 6(b)(1) which applied, rather than 6(b)(2). (Tr. June 6, 1977 p.17).

earmarks of an actionable course of doing business are not proscribed in any way ^{14/} and some of the activities sought to be proved, although actionable, ^{15/} do not rise to the order of a violation for which an injunction should issue. Indeed, the most serious allegations made by the Commission in this case are frequently the subject of administrative proceedings at the Commission itself. No injunction has ever been issued for any of the practices alleged in the Commission Complaint.

The statute itself offers little guidance with regard to the nature of the violation or threat of violation which rises to the degree of seriousness to warrant an injunction:

"The Commission may bring an action... to enjoin such act or practice, or to enforce compliance with this act, or any rule, regulation or order thereunder....upon a proper showing a permanent or temporary injunction shall be granted without bond....

7 U.S.C. 13(a)(1) (emphasis added)

Care must be taken at this point to distinguish between what is known as a "bucket shop" on the one hand, and what is known as a "boiler room" on the other. ^{16/} The former describes a practice which is clearly illegal, dangerous, and proper subject matter for injunction. There is no allegation in this case that any of the Defendants participated in "bucketing" or in any other "bucket shop practice". The latter is a term used by securities and commodities salespeople to describe the quarters provided for them by their employers. A "boiler

^{14/} Such as "cold canvas" selling, shared facilities and preplanned sales scripts.

^{15/} Such as discrepancy in authorized strike price, unexecuted sales orders, unauthorized purchases.

^{16/} T. Hieronymious, Commodity Futures Trading

room", although uncomfortable, is not illegal. Many firms sell securities and commodities out of quarters shared with heating equipment and worse.

Noteworthy is the Commission's opening statement:

"The Plaintiff's theory of this case is that the Defendants were running a boiler shop, (sic), and by that I mean that they preyed on unsophisticated investors through cold canvas, long distance telephone calls, through high pressure; they lured these investors with the promise of enormous profits with virtually no risk; they used psychological ploys to overcome sales resistance; they made false statements; they made misleading statements; and they omitted to make statements as to material facts".

(Tr. June 6, 1977, page 41). (There is no such thing as a boiler shop).^{17/}

The Commission's theory, apparently, was to accumulate allegations, some innocuous and non-actionable (akin to the allegation of "boiler room"), some administratively actionable, and to argue that taken all together with evidence of their ongoing nature, they are serious enough to warrant the issuance of an injunction.

The Court first ruled that it would be unnecessary to show the practices were ongoing.

^{17/} Mr. Boracks used the term several additional times in his opening statement (Tr. June 6, 1977 45).

"If there has been the pervasive conduct which the Plaintiff charges and if the professor (so in original, should probably be "proof") supports the charge, I'm telling you, gentlemen, now[,] I will grant the preliminary injunction. There isn't any point in saying that they are out of business and they won't engage in it again."

(Tr. June 2, 1977, at 41).

Defendants were thus thrust into the role of offering evidence at a hearing on a Preliminary Injunction, on three days' notice, concerning unspecified, ^{18/} and perhaps numerous, ^{19/} allegations which are normally the subject of administrative actions. Failure to dispose of the allegations would result in the promised injunction.

Under such circumstances, the importance of effective cross examination, to disprove the as yet unspecified allegations, was significantly amplified. The Court, however, denied even a short recess. (Tr. June 6, 1977, page 56).

It has been held that denial of adequate time to prepare for a hearing on a preliminary injunction, when such time is available, as it was herein, is grounds to vacate the injunction, should it issue. In the case of Marshall Durbin Farms, Inc. v. National Farmers Organization 446 F.2d 353 (5th Cir. 1971) a District Court's order of preliminary injunction was vacated for the reason that Defendants had not been afforded ample opportunity to read and controvert numerous affidavits served upon them within a few days of the hearing. There, as here, an injunction was authorized by statute "upon proper showing".

^{18/} See Part VI, infra.

^{19/} From the order in which the material was served upon Defendants, they were unable to know, until after they returned from Florida (the evening of the hearing) the names of the witnesses who would appear.

Judge Godbold, in vacating the injunction, stated:

Two interrelated rights of the Defendants are critical to the case: fair notice and effective opportunity to controvert the facts adduced in support of Plaintiffs' motion. [F.R. Civ. P.] Rule 65(a) requires notice. It does not define what "notice" must be. But we know that it implies a hearing. "Hearing requires a trial of [issues] of fact. Trial of [issues] of fact necessitates an opportunity to present evidence" and not by only one side to the controversy.

The right of Defendants to present controverting factual data is illusory unless there is adequate notice of Plaintiffs' claims. "It goes without saying that the requirements of a fair hearing include notice of the claims of the opposing party and an opportunity to meet them." "**** the right to a hearing means the right to a meaningful hearing."

Durbin Farms, supra at 356 (citations omitted).

In Durbin Farms, as in the case at bar, the Complaint encompassed a pattern of alleged violations, but failed to allege specific incidents.

In the inverse line of cases, those which uphold the trial Court's order, one finds, in virtually every case, equities weighing against the Defendants cited in the Court's decision. Any and all such equities are absent in the case at bar. See, for example, Avery v. Alabama, 308 U.S. 444, 60 S. Ct. 321, 84 L.ED. 377 (1940) (only two possible witnesses, Defendant and mother of the deceased, and both were before the Court, no suggestion of missing evidence, failure to make timely request for additional time); Locke v. U.S., 166 F.2d (5th Cir. 1948, Cert. denied, 334 U.S. 837, 68 S. Ct. 1495, 92 L. ED. 1763 (1948) (59 days from indictment to trial); NLRB v. American Potash & Chem. Co., 98 F.2d 488 (9th Cir. 1939) Cert. denied, 306 U.S. 643, 59 S. Ct. 582, 83 L. Ed. 1043

(1939) (same complaint filed 6 months and again 3 months earlier, no contention that any relevant evidence was not introduced at trial); Issacs v. U.S., 159 U.S. 487, 16 S. Ct. 51, 40 L. Ed. 229 (1895) (49 days granted to procure witness, no showing of use of due diligence or attachment to procure said witness, or that same proof not available from other witness); Anderson v. Yungkau, 329 U.S. 482, 67 Supreme Court 428, 91 L. Ed. 436 (1947) (statute of repose, to insure speedy distribution of estate); NLRB v. Somerville Buick, 194 F.2d 56 (1st Cir., 1952) (one attorney unavailable due to wife's illness, no showing that other attorneys in firm were unavailable and no showing of prejudice); NLRB v. Algoma Plywood & V. Co., 121 F.2d 602 (7th Cir. 1941) (defense witness and officers of defendant in Florida due to rigors of Wisconsin climate); Schackow v. Government of the Canal Zone, 108 F. 2d 625 (5th Cir. 1939) (18 days from preliminary hearing until trial, case was one of national security); Graham v. Penn R.R., 342 F.2d 914 (CA D.C. 1965), (no abuse to deny extension under 6(b) for reason that attorney's "rules service" was not up to date).

Defendants submit that the record herein is barren of these equitable factors which justify provisional injunctive relief. We refer to factors such as those found in each of these last cases cited. Absent such factors, the conclusion must be drawn that there is insufficient evidence to support a Preliminary Injunction imposed after strenuous objections as to lack of time to prepare.

That Defendants were in fact prejudiced due to shortness of time is manifest from the record. An outline of some of the major points follows:

1. Counsel for the Commission served its completed list of witnesses upon the Defendants after they returned from Florida. Thus,

all business records pertaining to those witnesses were of necessity still in Florida at the time of the hearing, (Tr. June 6, 1977 p. 24). Counsel for CROWN COLONY, Mr. Kaplan, in his opening statement promised to show that the government witnesses had all lost money and bore a grudge against the Defendants. In fact, some of the witnesses had made money through their dealings with CROWN COLONY.

2. Mr. Reed, counsel for ALTER and STEINER did not have time to familiarize himself with even the rules of service of process. (Tr. June 6, 1977, page 6).

3. All defense counsel were concerned from the outset that serious harm would flow to their clients should a Premanent Injunction issue.^{20/} It was decided that one attorney would inquire of the Judge as to his possible intention to consolidate under Rule 65. When the Court indicated that consolidation was a distinct possibility (Tr. June 2, 1977, p. 42, June 6, 1977, p. 35), it was decided that calling no Defendants as witnesses would be the only way to prevent consolidation.

4. The only evidence from which one could infer that the alleged violations were continuous and ongoing and not limited to those few actually testified to, came from one former employee of CROWN COLONY. Although his direct testimony revealed a highly unlikely state of affairs, defense counsel was able to present only one impeachment witness. With time to locate and subpoena the remainder of the CROWN COLONY employees, and others, the remainder of his testimony would have been shown to be subject to distortion and bias.

^{20/} NASD Rules--Mr. Goldschmidt, prior to his dealings in commodities, had ten years of service in the securities industry with no blemishes on his record.

A recent development in the U.S. Supreme Court suggests that the principle that a trial Court's discretion in these matters cannot be overturned absent a showing of abuse of discretion is not to be so strictly enforced as the authorities cited might suggest. In Ehrlichman v. Sirica, 419 U.S. 1310 (1974), the trial Judge denied a motion to extend time in order to prepare more fully and since the trial was several days in the future, immediate appeal was taken in the form of mandamus. The D.C. Court of Appeals did not issue the mandamus, but instead suggested that three or four additional weeks be granted for the purpose of preparation. The trial Judge conformed with the suggestion and granted the additional time. This entire episode was found by the Supreme Court to be a proper exercise of the case management and supervisory power of the Court of Appeals.

Unlike the Watergate Defendants, the Appellants in the case at bar did not have the initial week's time in which to lodge an appeal.

It is not to be expected that a Court of Appeals would be permitted to intervene in the trial management practices of a District Judge who, like Judge Sirica, allowed at least enough time to lodge an appeal and not those of the instant Court, who did not allow even that much time. A finding of abuse of discretion is therefore not required as a prerequisite to finding that there was not sufficient time to prepare.

Defendants urge upon the Court that this situation was additionally a denial of due process of law for the reason that

"While the due process clause of the Fifth Amendment guarantees no particular mode of procedure, it does require adequate notice of opposing claims, reasonable opportunity to prepare and to meet them". Brotherhood of Railroad Train v. Chicago M. St. P. & P.R. Co., 237 F. Supp. 404 (D.C.D.C. 1964) (Citations omitted).

The denial of adequate time to prepare is, therefore, three ways erroneous. First, the record is barren of equitable factors sufficient to support the ruling. Second, a denial of additional time when there is no good reason therefore is an abuse of judicial discretion and erroneous case management practice. Last, the denial denies due process in that it denied Defendants their opportunity to be heard.

POINT II

A PRELIMINARY INJUNCTION SHOULD NOT
ISSUE FOR ALLEGED VIOLATIONS OF AN
ANTI-FRAUD STATUTE ABSENT INQUIRY
INTO THE TRADITIONAL CONSIDERATIONS
OF THE COURTS OF EQUITY.

The District Court's structured its opinion according to the following logic:

- 1 - evidence of past violations permits inference of future violations;
- 2 - future violation constitutes cognizable danger;
- 3 - danger requires injunction.

CROWN COLONY submits that a Court of equity should not cut and paste earlier holdings to the neglect of the traditional equitable considerations. Analysis of related higher Court case law reveals this to be unacceptable decision making.

In the case of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) the United States Supreme Court had occasion to examine the related question whether scienter (there defined as "a mental state embracing intent to deceive, manipulate or defraud") was a necessary element of proof in a civil suit for damages brought under Section 10(b) of the Securities Act of 1934.

The Court held that such a mental state is a necessary element of proof. Its reasoning is instructive, because of the remarkable similarity that the history and structure of the securities laws, there under construction, bear to the commodities laws offered for judicial construction in the case at bar.

The Court first compared the Agency written Rule 10(b)(5) (the Anti-Fraud Rule) with the congressionally authored Statute §10(b) from which it derived. Such comparison revealed the original statutory language to be more restrictive than its translation into rule. Specifically, the statutory language "manipulative or deceptive" and "device or contrivance" implied that to be violative of the act, Defendant's conduct would have to involve scienter. The language of the rule, on the other hand, was broad enough to proscribe negligent and non-knowing acts, as well as those which originate from conscious choice.

Remarkably, a similar analysis of the pertinent statute and rule in the commodities legislation has already been made judicially. In the case of CFTC v. J.S. Love & Associates Options, Inc., 422 F. Supp. 652 (S.D.N.Y. 1976), Judge Bonsal traced the origin of the rule operative in the instant case:

"in further explaining Rule 30.01 the CFTC noted:
in the rules it has adopted, the Commission has not used the concept of willful behavior, which is reflected in the statutory language [of §4(b)]." 22/

Judge Bonsal further noted that the CFTC even distinguished two prior cases which had required proof of willfulness to establish a violation.

Should the Supreme Court subject the Anti-Fraud Rule here sought to be construed to the same analysis it used in Hochfelder, supra, the requirement of willfulness would no doubt emerge. The commodities statute is even more explicit in its requirement of willfulness than is its securities counterpart.

22/ Defendants note in passing that the reason advanced by the Commission for adoption of the particular "not willful language" is basically an attempt to conform the commodities rules with what the Commission understood at the time to be the then existent (i.e. pre-Hochfelder) securities rules, See 40 F.R. 26504, June 17, 1975. Such rationale does not square with the requirements of 7 U.S.C. §12(a)(5) which grants rulemaking power to the Commission in the first place "to effectuate the provisions of the act or to accomplish the purposes of the act". Analogy with the SEC rules is neither a provision nor a purpose of the CFTC Act. "The Rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is the power to adopt regulations to carry into effect the will of Congress as expressed by the statute". Hochfelder, supra at 99,424 (citations omitted). See also Kennecott Copper Corp. v. E.P.A., 462 F.2d 846,850. (CA D.C. Cir. 1972)

Secondly, in Hochfelder, the Supreme Court looked to the other provisions in the Securities Exchange Act which provide remedies for the wrongs complained of. In each case, procedural safeguards had been carefully drawn. By contrast, no procedural safeguards were present in a suit under 10(b). Such safeguards include provisions for bond, attorney's fees, statutes of limitations, and payment of costs. The Court's language is instructive:

"We think these procedural limitations indicate that the judicially created private damage remedy under §10(b)-- which has no comparable restrictions-- cannot be extended, consistently with the intent to Congress to actions premised on negligent wrongdoing. Such extension would allow causes of actions covered by §11, §12, §14 and §15 to be brought instead under §10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions. See, e.g., Fishman v. Raytheon Mfg. Co., 188 F.2d 783 786-787 (CA 2 1961); SEC v. Texas Gulf Sulphur Co., 401 F.2d at 867-868 (Friendly, J. concurring); Rosenberg v. Globe Aircraft Corp., 80 F.Supp. 123, 124 (ed. pa. 1948); 3 L. Loss, Securities Regulation 1787-1788 (Second Edition 1961); R. Jennings & H. Marsh Securities Regulation 1070-1074 (3rd edition, 1972). We would be unwilling to bring about this result absent substantial support in the legislative history, and there is none". 23/

Ernst & Ernst v. Hochfelder, supra.

23/ Precisely those safeguards which would prevent the issuance of a far reaching penalty upon inadequate notice and preparation which is complained of in Part I of this appeal, is what is at stake. As recently as October 6, 1977, an administrative law Judge has held that a failure of a customer to make a timely objection to a trade ratifies the trade. Cleveland v. Clayton Brokerage of St. Louis, ¶20,490. Compare testimony of C. Edgar Andelhelm, Tr. June 6, 1977, 116 et.seq. (ratified earlier trade).

The same reasoning is inescapable in the case at bar. Permitting a Preliminary Injunction to short circuit carefully drawn procedural safeguards, absent a clear legislated intent to that effect, is not consistent with the proper role of the Federal Court when sitting in Equity.

Appellants are not unmindful of the fact that the paragraph cited above applies to a judicially created private remedy while the case at bar involves a statutorily created regulatory remedy. Nor are we unmindful of the distinctions which have been drawn between disciplinary actions and injunctive actions. To argue, however, that these differences create lines across which, once drawn, a Court of Equity must not tread, amounts to a claim that these courts should cease to exist.

The role of the Court should not be to compartmentalize itself anymore than it should be to act as a rubber stamp for the administrative bodies which come before it. The authority relied upon by those who would support the agencies' right to rule the Court in this manner is not without reputable disagreement. ^{24/}

"We do not mean to imply that Courts should administer [statute] grudgingly. We repeat what we stated in United States v. Morgan, supra, (307 U.S. 183, 83 L. ed 1217, 59 S.Ct. 795 (1939) respecting judicial review of administrative action: "Court and agency are not to be regarded as wholly independent and unrelated instrumentalities of justice, each acting in the performance of its prescribed statutory duty without regard to the appropriate function of the other in securing the plainly indicated objects of the statute. Court and agency are the means

^{24/} Compare 3, L. Loss, Securities Regulation 1979, and 3 Moore's Federal Practice and Procedure 96.08 with Hecht v. Bowles, 321 U.S. 321 and Wright Miller, "Federal Practice & Procedure" §2948 at 460, 461, 619 620.

adopted to attain the prescribed end, and so far as their duties are defined by the words of the statute, those words should be construed so as to attain that end through co-ordinated action...."

Hecht v. Bowles, 321, U.S. 321 (1943).

The inconsistencies in which the Court does not allow itself to participate--absent a clear Congressional mandate--in judicially created remedies, are not sanctioned in statutory remedies when the Congressional mandate is likewise lacking. By providing that "upon proper showing an injunction issue", the Congressional mandate is clear: Congress chose to invoke those equitable considerations traditionally used by the Courts of Equity.

"We are dealing with the requirements of equity practice with a background of several hundred years of history. Only the other day we stated that "an appeal to the equity jurisdiction conferred on Federal District Courts is an appeal to the sound discretion which guides the determinations of the Courts of Equity". The historic injunctive process was designed to deter, not to punish. The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mold each decree to the necessities of the particular case. Flexibility, rather than rigidity has distinguished it. The qualities of mercy and practicality have made equity the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims. We do not believe that such a major departure from that long tradition as is here proposed, should be lightly implied."

Hecht v. Bowles, 321 U.S. 321.

The Congressional intention underneath the CFTC Act, moreover, is clear. The injunction was not to be used save in situations where a careful determination had been made that it was the most appropriate form of relief.

"[The Committee] is concerned that the authority provided not be abused by the Commission. Accordingly, the Committee intends that the authority provided by this section be viewed by the Commission as power to be exercised with caution and with an eye to any disruptive effect beyond the scope of the interests to be protected through the seeking of such an injunction or order. The Committee assumes that there will be an informal determination by the Commission that other remedies provided by this or other acts are inadequate or not realistic to the fact situation then being addressed by the Commission before seeking an injunction."

H.R. 13113 Report #93-975, CFTC Act of 1974, April 4, 1974.

Arguments such as those advanced by the Commission and by the Court below that "an injunction is not prohibited", or "an inference is permitted" are grossly inconsistent with this mandate, and the mandate of the history of the Courts of Equity that an injunction be issued where appropriate.

Against the background of agreement between the Supreme Court and Congress to the effect that the injunctive power is to be used consistently with the practices of equity and not inconsistently with the remainder of the statutory scheme, we propose that the Court below erred in ignoring these considerations.

However the Court may choose to add and weigh these considerations the result must be the same: a Preliminary Injunction must not issue during the pendency of a litigation absent a careful consideration of them all. ^{25/}

1. Scienter
2. Materiality
3. Reliance
4. Interest sought to be protected by the statute
5. Seriousness of past violations
6. Likelihood that alleged wrong will be repeated during pendency of litigation
7. Danger if injunction not issued during pendency of litigation
8. Hardship if injunction wrongfully issued
9. Other available remedies
10. Delay in bringing a Preliminary Injunctive action

We propose to analyze each of these elements briefly in order and show in each case where the equitable balance lies.

1. Scienter - Although the Commission regularly maintains that proof is not necessary in these matters and, therefore, did not plead the same, the Court below made no finding specifically with respect to the presence or absence of scienter. This matter has already been discussed above.

^{25/} Other formulations, such as that offered by Professor Moore, (7, J. Moore, Federal Practice & Procedure, ¶65.18[3] do not change the result. Defendants do not propose the following of any particular Hornbook formula.

2. Materiality - Once again, the Commission did not plead and the Court did not find materiality.^{26/} Even assuming defective disclosure of such items as the cost breakdown of the fee charged if a customer chooses to exercise his option, or of the fact that the individual options are not registered in the name of the individual customers with the ICCH, a record absent argument germane to the materiality of these items cannot produce a result which is supported by a finding that there has been material disclosure.

3. Reliance - There is a significant absence on the record of any statement by any witness that there was an omission or a misstatement upon which the investor relied, which reliance acted to his detriment.

4. Interest sought to be protected by the statute - There is no question but that commodities are significantly different from securities. Two respects in which they differ greatly are the volatile nature of the commodity contract as opposed to the more permanent character of the security and the fact that there is no reasonable analogy in commodities to the person known as the "promoter" in securities. Whereas the number of securities that can be issued at any one time is entirely fixed by the charter of the corporation issuing it, the number of futures contracts and hence options is entirely dependant on the rules of supply and demand. There is no fixed relationship between the quantity of a commodity produced and the number of contracts written on that commodity. For these reasons and others, the fundamental premise of statutes regulating commodities is different from that of the statutes regulating the securities. For one thing, in

^{26/} The Securities analogy requires a finding that there is a likelihood that the fact would have assumed "actual significance" in the deliberation of a reasonable shareholder. TSC Industries v. Northway, Inc., 426 U.S. 438 (1976).

commodity regulation, the most important interest sought to be protected is the commodity exchange, while in security regulation it is very clearly the consumer or purchaser of the securities.^{27/} Even assuming, arguendo, that the consumer is the party sought to be protected by the statute herein sought to be enforced, no interest would be served by the present preliminary injunction, for the reason that the Defendants herein are no longer in the business of offering for sale commodity options.

5. Seriousness of past violations - There is no claim that options were sold "naked", i.e., for which a corresponding contract was not purchased, nor that options were bucketed or traded for the private account of the Defendants. The scale of the alleged violations must be seen in its proper prospective. The worst that could happen to any customer in the circumstances of this case is that (s)he would receive a fair return for the option purchased. Substantial markup is one of the best guarantees of customer protection.^{28/} Defendants, TENNEY and GOLDSCHMIDT, moreover, have between them 20 years of unblemished records in the securities field.

6. Likelihood that alleged wrong be repeated during pendency of litigation - There was absolutely no likelihood that the wrong would recur during the pendency of this litigation since Defendants were out

^{27/} Defendants propose to brief this point before trial.

^{28/} The popularization and aggressive marketing of commodity options that began in 1971 represented a threat of financial irresponsibility that was recognizable immediately to those in the business who had been dealing in options legitimately for many years. The telltale indicator was the low level of premiums being charged--at such prices options could be sold and premiums pocketed but since no hedging could be done, bankruptcy was inevitable. Many of the more responsible participants in the international metals markets attempted quietly to caption regulators and members of the media to the clear dangers.

Commodity Trading Commission Act of 1964: Hearings on H.R. 11955 before the Committee on Agriculture. 93rd Congress, Second Session 194, Serial 93-II, Statement of Henry G. Jorecki.

of business and also within the jurisdiction of the Court. The Court could achieve the desired protection by ordering the Defendants to cease all operations pendente lite or by accepting the substantial bond, which they offered to the Court. (Tr. June 2, 1977, p. 18).

7. Danger if injunction not issued during pendency of litigation.
Same as 6.

8. Hardship if injunction wrongfully issued - Issuance of injunction can be grounds for revocation of licenses in both securities and commodities industries. Defendant, GOLDSCHMIDT, in particular, had a 10 year record in the securities industry without a single complaint having been lodged against him. His reputation and livelihood was at stake. (Stipulation No. 5, Tr. June 2, 1977, P. 39; Tr. June 6, 1977 p. 418).

9. Other available remedies - For every wrong complained of in this case, the Commission has a less drastic administrative remedy available.

Especially significant is the consideration that this Appeal is taken from a preliminary injunction. Both Defendants' affidavits state that business had ceased and also Defendants' offer of an undertaking, or bond, that they would engage in no offer or sale of commodity options pendente lite were before this Court. Either item should be sufficient to allay any fears of consumer harm or damage to the commodity exchanges. The Court rejected both, in favor of the more powerful and drastic preliminary injunction.

Regulation of exchanges, however, properly demands a gentle hand:

"People will endeavor to forecast the future and to make agreements according to their prophecy. Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices and providing for periods of want. It is true that the success of the strong induces imitation by the weak, and that incompetent persons bring themselves to ruin by undertaking to speculate in their turn. But legislatures and courts generally have recognized that the natural evolutions of a complex society are to be touched only with a very cautious hand, and that such coarse attempts at remedy for the waste incident to every social function as a simple prohibition and laws to stop it's being are harmful and vain". Mr. Justice Holmes. Board of Trade v. Christie Grain & Stock Co., 198 U.S. 236 (1905). (As quoted in Senate report #93-1131 93rd Congress, Second session, August 29, 1974 entitled CFTC Act of 1974).

10. Delay in bringing the Preliminary Injunctive action - The Commission waited at least 7 months from the onset of its investigation and at least 3 weeks from the time the company went out of business to bring its action. A Preliminary Injunction is especially unwarranted where the complainant delays in bringing the action. The Court should, of course, weigh the delay more heavily against the tardy party in a Preliminary Injunctive action.

Considering them individually, and also in the aggregate, Defendants, CROWN COLONY, GOLDSCHMIDT and TENNEY respectfully submit the balance of these equitable considerations tips decidedly against the extraordinary relief requested by the Commission.

This is all the more noteworthy in the light of the reasons advanced by counsel, in his closing argument, for the issuance of the Preliminary Injunction:

"I ask this Court on behalf of the Plaintiff, and mindful of the presumption of my remark, "In the public interest," to say to the Defendants, and by implication to the commodity options industry such as it is, "Don't ever do this again; if you do, you will have this Court to answer to." (Tr. June 6, 1977 p. 544).

Such reasoning, if appropriate at all, justifies a permanent injunction only. Any restraint during the pendency of the litigation for the purpose of aiding the Commission to advertise its presence to the industry, at the expense of one Defendant, and before the facts are fully decided, is wholly beyond the scope of the reasons for which provisional relief is granted.

For these reasons, Defendants submit, not only is a Preliminary Injunction erroneous because it represents a failure of the trial Court to analyze the true legislative intent of the statutory underpinning of the rule if enforced, but also because, under a proper equitable analysis, the facts of this case do not warrant preliminary injunctive relief.

POINT III

IT IS ERROR FOR THE COURT TO PROMULGATE
ITS ORDER WITH RESPECT TO DEFENDANT,
TENNEY, SINCE HE WAS NOT PROPERLY SERVED
NOTICE AT THE TIME OF THE HEARING ON THE
PRELIMINARY INJUNCTION.

On June 6, 1977, in the first moments of the hearing on the Preliminary Injunction, counsel for Defendant TENNEY represented to the Court that his client, ARNOLD TENNEY, a resident of Canada, had not been served notice of the hearing.^{29/} The Court inquired of counsel for the Government as to the manner in which service had been made. Counsel for the Government replied that service had been attempted by a mailing performed by the Clerk of the Court, such mailing requiring a signed receipt. Counsel for the government represented that this mailing was in accordance with the provisions of Federal Rule of Civil Procedure 4 (i) (1) (D).^{30/}

Since proof of the mailing itself was lacking in the Court's record, counsel for the Government proffered to the Court a witness who had performed the mailing. Although the witness was never heard, the Court ruled that such a proffer would be sufficient to satisfy the requirements of Rule 4.^{31/}

Defendants acknowledge that Rule 4 permits service upon a foreign Defendant by any form of mailing performed by the Clerk of the Court

^{29/} Transcript of June 6, 1977, page 12.

^{30/} id.

^{31/} The trial Court apparently suffered a mistaken belief at the time of trial that if a particular defendant were not before the Court, the Court could entertain a motion for a Temporary Restraining Order, Ex Parte. (See Transcript June 2, 1977, p. 43).

requiring a signed receipt. Defendants urge upon the Court that proof of the mailing alone is insufficient to satisfy the requirements of notice. The Rule requires more than that a mailing be performed. When read in its entirety it requires that service be made by a mailing which is performed in the manner specified. Absent proof that service has actually been made according to the manner specified, service is incomplete and the Court lacks jurisdiction over the Defendant. Bersch v. Drexel Firestone, Inc., 389 F. Supp. 446 (Sec. Cir. 1974).

Defendants respectfully direct the Court's attention to the remainder of Rule 4, Section 4(i)(2), in particular which states:

"When service is made pursuant to [Rule 4(i)(1)(D)], proof of service shall include a receipt signed by the addressee satisfactory to the Court."

When counsel for Defendant, TENNEY, directed the trial Court's attention to the fact that "a mailing" was not the same as "service", and that for the former to give rise to an inference of the latter, a signed receipt was required, his Honor replied:

"It says 'Requiring a signed receipt.'
It doesn't say the receipt must be submitted."

(Tr. June 6, 1977, at 16, 17).

Since he received no notice of the hearing, the trial Court's order of Preliminary Injunction becomes an Ex Parte Injunction as to Defendant TENNEY. It is, therefore, ineffective with respect to

Defendant TENNEY both for the other reasons cited in this brief and for the reason that Ex Parte Injunctions are not permitted to the Federal Courts in actions brought by the CFTC.^{32/} 77 U.S.C. §13a-1.

POINT IV

THE COURT BELOW ERRED IN REFUSING TO
ORDER THE PLAINTIFF TO CONFORM ITS
COMPLAINT TO THE REQUIREMENTS OF FEDERAL
RULE OF CIVIL PROCEDURE 9 (b)

Under the system of notice pleading adopted by the Federal Rules, "a short and plain statement of the claim" that gives the Defendants notice of the claim and the grounds upon which it rests is sufficient. Conley v. Gibson, 355 U.S. 41, 47 (1957); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971). Fraud, however, is a grave charge with serious repercussions in the business world; it is not to be lightly bandied about and "cavalierly appended to other claims for [its] presumed in terrorem effect." Lewis v. Varnes, 368 F. Supp. 45, 47 (S.D.N.Y. 1974). See also, Segal v. Gordon, 467 F.2d 602, 608-08 (2d Cir. 1972); Walner v. Friedman, 410 F. Supp. 29, 33 (S.D.N.Y. 1975). Consequently, the Courts, pursuant to Rule 9(b), F.R. Civ. P. have required more than "[m]ere conclusory allegations to the effect that Defendant's conduct was fraudulent or in violation of Rule 10b-5...." Shemtob v. Shearson, Hammill & Co., supra, at 444.

^{32/} The legislative history of the CFTC Act is ripe with cautions against the liberal use of the injunction in the regulation of commodities. the Ex Parte injunction, in particular, was abandoned in the first committee report. Committee on Agriculture, hearings on H.R. 11955 (Serial No. 93 tt) January 23, 1977 at 43,44 and 186; H.R. Rep. No. 93-975 at 14 and 30.

A complaint that does no more than track the language of the Anti-Fraud Statute in haec verba is likewise inadequate. SEC v. Republic National Life Insurance Co., 378 F. Supp. 430 (S.D.N.Y. 1974).

"This complaint is totally deficient in this regard. It alleges no facts amounting to deception in one form or another..." O'Neil v. Maytag, 339 F.2d 764, 768 (2d. Cir. 1964).

Defendants moved immediately for an order to dismiss or to give more particularity at the outset of the hearing on June 6, (Tr. June 6, 1977 p. 31), as well as to strike that which was scandalous and unnecessary. The Court ruled that the pleadings were sufficiently clear and succinct. (Tr. June 2, 1977 p. 32).

Noteworthy is the fact that although each averment in Counts 1, 2 and 3 alleges multiple transgressions, no complainant, no date, and no particular transaction is mentioned. Such pleadings violate the letter as well as the spirit of Rule 9(b) and failure to order their ratification is error.^{33/}

POINT V

THE ANTI-FRAUD STATUTE VIOLATES THE
FIFTH AMENDMENT TO THE CONSTITUTION,
AS INTERPRETED, BECAUSE IT BEARS NO
RATIONAL RELATIONSHIP TO THE END
SOUGHT TO BE ACHIEVED.

The Due Process Clause of the Fifth Amendment is the origin of the requirement that to pass constitutional muster a federal regulation or statute must, either as written or as applied by the Courts, bear a rational relationship to the end sought to be achieved.

^{33/} See Felton v. Walston & Co., Inc., 508 F.2d 577 (2d. Cir. 1974) and the annotation at 27 ALR Fed. 407.

"[T]he guarantee of due process, as has often been held, demands only that the law shall not be unreasonable, arbitrary or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained.
Nebbia v. New York, 291 U.S. 502 (1934).

The Anti-Fraud and Disclosure Rules promulgated by the Commission although apparently rational on their face, lack any rational relationship to their professed ends insofar as they provide for the issuance of a Preliminary Injunction in circumstances in which there is no possibility that the activity enjoined will occur.

"It was said by Mr. Justice Miller in delivering the opinion of this Court in Davidson v. New Orleans, 96 U.S. 97 (1877) that the words "law of the land" as used in the Magna Charter, implied a conformity with the "ancient and customary laws of the English people" and it was wiser to ascertain their intent and application by the "gradual process of judicial inclusion and exclusion, as the case is presented for decision shall require, with the reasoning on which such decision may be founded." Recognizing the difficulty in defining, with exactness, the phrase "due process of law" is certain that these words imply a conformity with natural and inherent principles of justice, and forbid that one man's property, or right of property, shall be taken for the benefit of another, or for the benefit of the state, without compensation; and that no one shall be condemned in his person or property without an opportunity of being heard in his own defense.

Holden v. Hardy, 169 U.S. 366 (1898).

If the Anti-Fraud Statute is to be allowed to operate, absent proof of "scienter", "materiality" and "reliance", the Act, taken as a whole is irrational in that it allows harsher penalties (i.e. injunction) upon a lesser showing and requires for lesser penalties (i.e. suspension) greater proof and procedure.

CONCLUSION

Defendants, CROWN COLONY COMMODITY OPTIONS, LTD., ALLEN M. GOLDSCHMIDT and ARNOLD TENNEY were denied due process of law, a reasonable opportunity to adequately prepare for and defend the case. This denial was an abuse of discretion. A Preliminary Injunction should not have been issued in the absence of scienter, plus the other equitable considerations on the part of the Defendants. The Preliminary Injunction was not effective as to Defendant, ARNOLD TENNEY. Further, the District Court should have granted Defendants' Joint Motion to Dismiss or, in the alternative, for a more definite statement of the Complaint. Moreover, the Anti-Fraud Statute violates the Fifth Amendment of the Constitution because it bears no rational relationship to the end sought to be achieved. For the above reasons, Defendants CROWN COLONY COMMODITY OPTIONS, LTD., ALLEN M. GOLDSCHMIDT and ARNOLD TENNEY request that the Preliminary Injunction be vacated.

Dated: January 1978

Respectfully Submitted,

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STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.

RICHARD WITHERS, being duly sworn,
deposes and says that deponent is not a party to the action,
is over 18 years of age and resides at 1526 Webster Ave. Apt. B-3
Bronx, NY 10457.

That on the 10 day of JANUARY, 1978,
deponent personally served the within BRIEF OF DEFENDANTS-APPELLANTS
CROWN COLONY COMMODITY OPTIONS, LTD. ALLEN M. GOLDSCHMIDT & ARNOLD TENNEY
upon the attorneys designated below who represent the
indicated parties in this action and at the addresses below
stated which are those that have been designated by said
attorneys for that purpose.

~~By leaving~~ true copies of same with a duly
authorized person at their designated office.

By depositing 2 true copies of same enclosed
in a postpaid properly addressed wrapper, in the post office
or official depository under the exclusive care and custody
of the United States post office department within the State
of New York.

Names of attorneys served, together with the names
of the clients represented and the attorneys' designated
addresses.

1. RICHARD A. LEVIE, ESQ.
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ATTORNEY FOR PLAINTIFF-APPELLEE
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ATTORNEYS FOR DEFENDANTS-APPELLANTS
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MIAMI, FLORIDA 33138

Richard Withers

Sworn to before me this

10th day of January, 1978

MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Queens County
Commission Expires March 30, 1979

